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American Institute of Certified Public Accountants. Accounting Principles Board

OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

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Disclosure of Lease Commitments by Lessees

CONTENTS

Paragraph Numbers

Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants

INTRODUCTION

1. Since the adoption of APB Opinion No. 5, *Reporting of Leases in Financial Statements of Lessee,* in September 1964, the Board has observed improvement in disclosures of lease commitments by lessees. However, some investors, credit grantors, credit rating services, and other users of financial statements have stated that the disclosures have not always provided all of the relevant information they believe to be important.

2. These users of financial statements state that information with respect to expiration dates and minimum annual rentals under lease commitments is as essential as similar information with respect to long-term debt. Furthermore, they observe that comparisons of financial position, including capital structure and debt/equity ratios, of similar enterprises are impaired if the impact of lease commitments (and the major categories of leased properties) are not determinable from the financial statements of each company. Some have observed that, to make meaningful comparisons between enterprises that finance property acquisitions with long-term debt or equity capital and those that obtain the use of such properties under long-term noncancelable leases, it is necessary to calculate gross rental commitments and apply a "factor" to those amounts to estimate the present values of lease commitments. A "factor" must also be applied to rent expense in evaluating the ability of a lessee to meet fixed charges. These factors, generally arbitrary, have produced widely varying results in evaluating lease commitments in similar circumstances.

Differing Views

3. Some accountants believe that evaluation of lease commitments, as discussed in paragraph 2, would be aided by expanding disclosures to include (a) a description of the major categories of leased properties, (b) amounts of required lease payments due in future periods, (c) the present values of such payments after excluding the amounts applicable to taxes, insurance, maintenance, and other operating expenses (that is, on a net lease basis), and (d) interest rates used in computing the

present values. Some accountants in this group believe that in view of the matters discussed in paragraph 5 it is acceptable to call attention to the possible utility of giving the information referred to in (c) and (d) but not to make the disclosure of such information mandatory at this time.

4. Other accountants believe that the disclosure of the aggregate gross commitments arising from leases by time intervals and type of property and services is adequate to assess the extent to which operations are dependent upon leased property and the credit of the company has been committed. They believe that disclosure of present values of lease commitments (net leases and, if practicable, gross leases reduced by estimation to a net lease basis) improperly implies that such lease commitments should have been recorded as debt and resulted in capitalization of the related assets. The subjective nature of the estimates necessary to reduce gross leases to a net lease basis, in their view, would result in many cases in the still more inappropriate alternative disclosure of the present values of the portions of gross leases which represent future services. Further, they believe that the disclosure of two substantially different amounts with respect to the same lease contract can only add complexity and cause confusion.

Financial Accounting Standards Board

5. The Board recognizes that disclosure of lease commitments is part of the broad subject of accounting for leases by lessees, a subject which has now been placed on the agenda of the Financial Accounting Standards Board. The Board also recognizes that the forthcoming report of the Study Group on Objectives of Financial Statements may contain recommendations which will bear on this subject and which the FASB may consider in its deliberations. Accordingly, the Board is refraining from establishing any disclosure requirements which may prejudge or imply any bias with respect to the outcome of the FASB's undertaking, particularly in relation to the questions of which leases, if any, should be capitalized and how such capitalization may influence the income statement. Nevertheless,

in the meantime the Board recognizes the need to improve the disclosure of lease commitments in order that users of financial statements may be better informed.

Applicability

6. This Opinion supersedes paragraphs 16, 17, and 18 of APB Opinion No. 5 and should be substituted for the references to them in paragraphs 14, 20, and 23 of that Opinion. Except as stated in the preceding sentence, this Opinion does not modify APB Opinion No. 5. This Opinion applies to lease commitments for either personal property or real property, including leases of office space and special purpose facilities and of properties subleased to others. Because of the highly specialized problems involved, it does not apply to lease agreements concerning natural resources (such as oil, gas, timber, and mineral rights) other than land. Further, this Opinion does not apply to lease commitments that have been capitalized in accordance with APB Opinion No. 5.

OPINION

7. The Board believes that financial statements of lessees should disclose sufficient information regarding non-capitalized lease commitments to enable users of the statements to assess the present and prospective effect of those commitments upon the financial position, results of operations, and changes in financial position of the lessees. Accordingly, the Board believes that the information specified in paragraphs 8-10 should be disclosed as an integral part of the financial statements.

Total Rental Expense

8. Total rental expense (reduced by rentals from subleases, with disclosure of such amounts) entering into the determination of results of operations for each period for which an income statement is presented should be disclosed. Rental payments under short-term leases for a month or less which are not expected to be renewed need not be included. Contingent rentals, such as those based upon usage or sales, should be reported separately from the basic or minimum rentals.

Minimum Rental Commitments

9. The minimum rental commitments[1] under all noncancelable leases[2] should be disclosed, as of the date of the latest balance sheet presented, in the aggregate for:

a. Each of the five succeeding fiscal years,
b. Each of the next three five-year periods, and
c. The remainder as a single amount.

The amounts so determined should be reduced by rentals to be received from existing noncancelable subleases (with disclosure of the amounts of such rentals). The total of the amounts included in (a), (b), and (c) should also be classified by major categories of properties, such as real estate, aircraft, truck fleets, and other equipment.

Additional Disclosures

10. Additional disclosures should be made to report in general terms:

a. The basis for calculating rental payments if dependent upon factors other than the lapse of time.
b. Existence and terms of renewal or purchase options, escalation clauses, etc.
c. The nature and amount of related guarantees made or obligations assumed.
d. Restrictions on paying dividends, incurring additional debt, further leasing, etc.
e. Any other information necessary to assess the effect of lease commitments upon the financial position, results of operations, and changes in financial position of the lessee. (For example, in instances where significant changes in lease arrangements are likely it may be desirable to state that the information given is for existing leases only and is not a forecast of future rental expense. A statement could also be made that the amounts given may not necessarily represent the amounts payable in the event of default.)

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1 The minimum rental commitments are not necessarily indicative of the values of the property rights vested in the lessee.

2 For purposes of this Opinion a noncancelable lease is defined as one that has an initial or remaining term of more than one year and is noncancelable, or is cancelable only upon the occurrence of some remote contingency or upon the payment of a substantial penalty.

Present Value of Commitments

11. The Board also believes that disclosure of the present value of the commitments reported in accordance with paragraph 9 may be helpful in evaluating the credit capacity of the lessee and in comparing the lessee's financial position with that of other entities using other means of financing to obtain the use of property. Such disclosure, if presented, may include, as of the date of the latest balance sheet presented:

a. The present values of the net fixed minimum lease commitments[3] (based on the interest rates implicit in the terms of the leases at the times of entering into the leases[4]) in the aggregate and by major categories of properties, such as real estate, aircraft, truck fleets, and other equipment.

b. Either the weighted average interest rate (based on the present values) and range of rates, or specific interest rates, for all lease commitments included in the amounts disclosed under (a) above.

c. The present value of rentals to be received from existing noncancelable subleases of property included in (a) above (based on the interest rates implicit in the terms of the subleases at the times of entering into the subleases).

EFFECTIVE DATE

12. This Opinion shall be effective for fiscal periods ending on or after December 31, 1973 and applies to all lease agree-

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[3] The net amounts disclosed should exclude the estimated or actual portions, if any, of the lease commitments applicable to taxes, insurance, maintenance, and other operating expenses. To the extent that such expenses cannot be reasonably estimated for some leases, it is acceptable to disclose the present value of the aggregate of those lease commitments computed without regard to such deductions (that is, on a gross basis). In the latter case separate amounts should be presented for lease commitments determined on a net basis and for those determined on a gross basis.

[4] In some cases, the pertinent lease documents may indicate the interest rates inherent in the lease terms. In other cases, interest rates applicable to the financing of purchases of similar types of properties by the lessee at the times of entering into the lease agreements may be indicative of the interest rates implicit in the terms of the leases. Also, see APB Opinion No. 21, *Interest on Receivables and Payables*, paragraphs 13 and 14.

ments, including those entered into prior to the issuance of this Opinion. The Board, however, encourages earlier application of the provisions of this Opinion.

The Opinion entitled "Disclosure of Lease Commitments by Lessees" was adopted by the assenting votes of fifteen members of the Board, of whom four, Messrs. Bevis, Hellerson, Norr, and Watt, assented with qualification. Messrs. Bows and Halvorson dissented.

Mr. Bevis assents to the issuance of this Opinion because he believes it will improve disclosures of lease commitments by lessees. However, he also believes that disclosures by lessees of the present value of the net fixed minimum lease commitments under noncancelable leases (that is, both financing leases and operating leases) should be mandatory and not optional as permitted by paragraph 11 of the Opinion.

Mr. Hellerson assents to the issuance of this Opinion because paragraphs 7-10 more clearly describe and require the disclosure which was intended in paragraphs 16-18 of APB Opinion No. 5. However, he disagrees with the requirement for disclosing the information set forth in paragraphs 9 and 11 "by major categories of properties." In his opinion, separate disclosure of rental commitments relating to real and personal property should suffice. Further, he believes that the permissiveness in the application of paragraph 11 is contrary to the primary function of the Board to promulgate principles of accounting and standards of disclosure. Also, he disagrees with the suggested disclosures for present value data described in paragraph 11, including the use of interest rates implicit in the terms of the leases at the time of entering into the leases. He believes that this guideline presumes that lease commitments have certain attributes of non-capitalized debt and that this is inconsistent with the position taken by the Board in the third sentence of paragraph 5.

Mr. Norr assents with qualification. He believes that the Opinion should require a statement of the impact on net income if finance leases were capitalized. This would be computed in a uniform fashion, requiring amortization of the asset on a straight line basis and interest expensed on the basis of the declining lease liability. The amount of amortization and interest cost should be separately identified.

Mr. Watt assents to the issuance of the Opinion because it clearly requires disclosure of the total gross lease commitments by time intervals, which he feels was intended under most circumstances by paragraphs 16, 17, and 18 of APB Opinion No. 5. However he disagrees with the implication in paragraph 11 that it is "helpful in evaluating the credit capacity of the lessee. . . ." to know the present value (based on interest rates at the time of entering into the leases) of all leases with a remaining term of more than one year. He believes that it is proper to present value liabilities (and record assets acquired) and improper to present value mere commitments. Furthermore, even if disclosure of present value of commitments were desirable, the present value should be computed using the interest rate at the balance sheet date rather than at the date the commitments were entered into. In view of the statement of intent of the Board relative to cooperating with the Financial Accounting Standards Board, as described in paragraph 5, he believes this Board should not have indicated any views relative to present values of non-capitalized leases. His views are expressed in paragraph 4 of this Opinion.

Mr. Bows dissents to this Opinion because the disclosures of non-capitalized lease commitments specified are inadequate to achieve the objective stated in paragraph 7, i.e., "to enable users of the statements to assess the present and prospective effect of those commitments upon financial position, results of operations, and changes in financial position of the lessees." He believes that the inadequate standards set forth in APB Opinion No. 5 to guide accounting for lease contracts are perpetuated by issuance of this Opinion. Since the Opinion does not deal at all with the fundamental issues in accounting for lease contracts, he further believes that the disclosure of the present value of net fixed minimum lease commitments (paragraph 11) should be required, rather than being optional, for all leases for which the initial or remaining noncancelable term is in excess of one year.

Mr. Halvorson dissents to the issuance of the Opinion because in substance it does no more than specify the disclosure requirements which are already implicit in paragraphs 16, 17, and 18 of APB Opinion No. 5, and that in so doing it introduces a rigidity into the reporting process that goes beyond what is appropriate in a pronouncement on accounting principles. He further believes that the acknowledgment in paragraph 11 of the Opinion that information concerning present values may be of interest to some users of financial statements improperly implies that the subject leases should have been capitalized and thus constitutes tacit endorsement, be it ever so tepid, of an accounting method to which the Board has chosen not to address itself.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board.

Board Opinions need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Rule 203 of the Institute's Rules of Conduct prohibits a member from expressing his opinion that financial statements are presented in conformity with generally accepted accounting principles if the statements depart in a material respect from such principles unless he can demonstrate that due to unusual circumstances application of the principles would result in misleading statements—in which case his report must describe the departure, its approximate effects, if practicable, and the reasons why compliance with the established principles would result in misleading statements.

Pursuant to resolution of Council, this Opinion of the APB establishes, until such time as they are expressly superseded by action of FASB, accounting principles which fall within the provisions of Rule 203 of the Rules of Conduct.